GO Green Research and Education

Journal of Business and Management Research
ISSN:2958-5074 pISSN:2958-5066
Volume No:2 Issue No:1(2023)

Theoretical Examination of The Influence of Corporate Governance on Capital Structure.

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Abstract

The main aim of this study is to analyze how corporate governance impacts the capital structures of non-banking enterprises in Pakistan. The sample for this study comprises thirty significant Pakistani firms that either have a presence on the Karachi Stock Exchange (KSE) or have their headquarters located there. Through the application of ordinary least squares regression, we determined the specific relationship between corporate governance characteristics and the financial composition of the business. While Pakistani companies' corporate governance systems may not be considered highly innovative, the research indicates that they do have a certain level of influence on company structure. There appears to be a significant negative relationship between the debt ratio and the following factors: board of director composition, CEO dual function, ownership concentration, profitability, and available data. This relationship has statistical significance. Therefore, it is evident that a decrease in the debt ratio might occur as a consequence of an increase in any of these factors. The debt ratio is positively correlated with the size of the business, tangibility of assets, and director remuneration. It is important to highlight the positive and statistically significant relationship between the debt ratio and board size. However, it is important to note that there is no statistically significant association between the debt ratio and board size.

Introduction

Governance encompasses the responsibilities of arranging, overseeing, and directing, whereas "corporate" pertains to an entity characterised as a cooperative or collaborative arrangement of individuals working together to establish a larger group or organisation. The concept of governance is considered to have a wider scope than that of corporation. The term "corporate governance" encompasses the oversight, management, direction, and control of all aspects of a company's structure and operations. The efficacy and refinement of an organization's regulatory entities, encompassing directors, managers, and shareholders, can be augmented and optimised by adhering to a prescribed framework of rules, regulations, and guidelines. An often cited issue is the potential for implementing stringent governance rules to positively impact the financial framework of the organisation. Implementing corporate governance standards can enhance an organization's efficiency and performance by ensuring adequate monitoring and control mechanisms. Given this information, these procedures are crucial for aligning the objectives of shareholders and management, as well as minimising conflicts arising from conflicting interests. According to Shleifer and Vishny (1997), using this approach enables the company's capital provider to guarantee a favourable return on their investments. Companies that possess a robust

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ISSN:2958-5074 pISSN:2958-5066
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governance framework are more inclined to secure loans from investors. Stronger governance structures safeguard shareholders' interests, enhance transparency, and minimise conflicts of interest. Core et al. (1999) found that organisations lacking effective governance systems are more likely to encounter agency difficulties. This is likely due to the fact that managers employed by those organisations have the ability to easily gain personal advantages as a result of the insufficient institutional governance structure. Furthermore, it serves as an incentive for management to make decisions that are advantageous to shareholders, leading to an increase in shareholder value. Claessens et al. (2004) suggest that effective governance can be advantageous for a company. The benefits encompass facilitating the company's access to external funding, granting shareholders advantageous privileges, and reducing the cost of capital. Enhancing corporate governance systems is crucial in the context of emerging economies, such as those in Pakistan. This is because there is a correlation between having a more robust legal and financial standing and having an enhanced governance framework. Additionally, it facilitates the attainment of higher ratings from rating agencies, thereby streamlining the process of generating cash. The concept of corporate governance still has significant untapped potential for enhancement. Many developing nations are giving high priority to enhancing corporate management and administration to establish a more efficient governance structure. Businesses and corporations were established based on the principles of trust, openness, and responsibility. Conversely, the necessity to cultivate and adjust corporate culture emerged due to a substantial expansion in the company's scale, a rise in business intricacy, individual insolvencies, crises, and deceitful activities across diverse organisational systems and structures. Consequently, a multitude of regulations, laws, and principles have been established to enhance the organisation and functioning of businesses, with the aim of mitigating the likelihood of financial crises and overseeing the financial sector. The World Trade Organisation (WTO) and the International Finance Corporation (IFC) are aggressively supporting the dissemination of this notion by implementing and overseeing similar practices in client nations. The main objective of this research is to enhance understanding of the comprehensive influence that corporate governance exerts on both a firm's performance and its capital structure. Several theories and approaches have been created to examine the factors that lead to the enhancement of governance structure and evaluate the impact of this structure on the capital structure. Nevertheless, there has been a paucity of research on this subject in Pakistan. Conversely, this subject is becoming increasingly prominent due to the shortcomings of companies like Mehran Bank and Taj Company, as well as other incidents within enterprises caused by inadequate governance practices. In this study, a sample of thirty non-financial firms listed on the Karachi Stock Exchange between 2009 and 2011 was selected to serve as a representative sample. This article offers a concise introduction to the corporate governance principles employed in Pakistan, along with the listing criteria set by the Securities and Exchange Commission of Pakistan (SECP). The subsequent section offers a comprehensive analysis and assessment of the pertinent literature, methods, and overall findings. Pakistan's business culture is now in the nascent phase of adopting corporate governance practices, although it is quickly

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ISSN:2958-5074 pISSN:2958-5066
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becoming more popular throughout the country. There is a growing trend of people adopting this phenomenon. Pakistan's corporate governance framework is considered substantially inferior to those of other industrialised and developing nations. Conversely, the government is currently implementing measures to enhance and expand the country's commercial infrastructure. The intricacy of commercial processes escalates as organisations expand throughout time. Consequently, individuals have seen the importance of corporate governance in guaranteeing the stability of financial assets and the basis for operational structures. At first, there was significant resistance to the concepts of corporate governance because of concerns regarding the level of dedication and expenses involved. Gradually, a growing number of individuals have acknowledged the necessity of corporate governance. A significant number of Pakistani businesses are reluctant to use these strategies. The World Bank and the International Finance Corporation have published a multitude of documents on corporate governance. These articles offer evaluations and perspectives on the application of corporate governance regulations and principles in diverse nations. The acronym ROSC, derived from Reports on the Observation of Standards and Codes, encompasses a diverse range of literary works. The study was utilised to assess the organization's vulnerabilities, legal framework, structure, and shortcomings with the aim of establishing more efficient governance strategies. The Organisation for Economic Cooperation and Development (OECD) initially proposed the notion of corporate governance. ROSC conducted an examination of the mechanisms that oversee corporate governance, as per the recommendations of the OECD. The Securities and Exchange Commission of Pakistan (SECP) implemented timely structural reforms and established effective governance norms to ensure their implementation. The governance structure of the Institute of Chartered Accountants of Pakistan (ICAP) commenced its upgrade in 1998. In addition, the Security and Exchange Commission of Pakistan (SECP) implemented corporate governance regulations in March 2002. Publicly traded corporations are obligated to provide an additional report in accordance with corporate governance regulations, in addition to their annual reports. The objective of this report is to showcase the organization's adherence to the regulations. Consequently, auditors will assess and verify these reports to confirm that the company was established in compliance with corporate governance standards. The International Corporate Governance Association (ICAP) and the Pakistan Institute of Corporate Governance (PICG) are actively engaged in promoting awareness and knowledge among the people of Pakistan on the significance of corporate governance. In addition, the non-profit organisation, PICG, significantly contributes to the dissemination of this ideology in the region. These companies enhance the structure and functioning of corporate governance through the management training they offer to its employees. Furthermore, they administer yearly surveys to assess the overall state of Pakistan's corporate governance standards. Furthermore, the State Bank of Pakistan is actively engaged in the advancement and execution of a proficient governance framework. In addition, JCR-VIS is a credit rating agency that has obtained approval from both the Securities and Exchange Commission of Pakistan (SECP) and the State Bank of Pakistan. Both of these organisations are headquartered in Pakistan. It

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contributes to the assessment of corporate governance by determining the extent to which the company complies with the established principles of good governance that have been created since its establishment. Furthermore, the participation of the Pakistan Credit Rating Agency (PACRA) is crucial to the rating process. This strategy takes into account several factors, such as the organization's size, board makeup, qualifications, annual meetings, and the number of executive directors, among other considerations. The primary assertion is that this position is experiencing a surge in popularity.

Literature Review

In the past, scholars from many developed countries undertook multiple research to investigate the influence of corporate governance on the financial composition of companies. An empirical study aims to examine the advantages of efficient governance on the overall performance of an organisation, as well as the influence of ownership structure on the value of the business. Claessens (2002) illustrates the process by conducting a comprehensive examination of the pertinent literature. Graham, Harvey (2001), and Litov (2005) contend that a company's capital structure and financing choices are inherently interconnected with its corporate governance. Liao (2013) argues that strong governance allows organisations to efficiently manage their information, leading to a reduction in the overall cost of capital. Consequently, the company can enhance its ability to make more effective and prompt selections about its financial framework. It is important to mention that this is a recent finding made in Pakistan. Current research offers a range of viewpoints on how corporate governance affects capital structure. Academic research indicates that the adoption of corporate governance principles positively affects a company's capital structure. Academics are divided into two camps about the effects of corporate governance on a company's performance: one argues that it has a detrimental effect, while the other maintains the opposite perspective. Claessens et al. (2002) argue that adopting robust corporate governance standards enables organisations to gain the confidence of investors, resulting in improved access to capital and reduced borrowing costs. Owners of blocks has a greater ability to exert influence on decisions made by management. They possess the power to enforce management to make decisions that prioritise the welfare of shareholders and contribute to their overall success.Mehran (1992) found a significant and positive correlation between the debt ratio and the ownership structure of the major investor. This link is noteworthy due to its positive nature. "This relationship is characterised by a positive and significant correlation." It is important to note that the connection between the long-term debt ratio and this relationship does not continue over time. In 1976, Jensen and Meckling found that the ownership structure plays a crucial role in mitigating agency conflicts, hence ensuring the proper alignment of shareholders' and management's interests. The organization's corporate governance system often fails to meet expectations due to significant conflicts of interest between shareholders and managers. Fosberg (2004) establishes a clear link between the overall debt level in a company's capital structure and the ownership of shares by block holders. Conversely, there is a negative correlation between the

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total number of shares an individual possesses in the organisation and the number of individuals who own a significant number of shares. An indicator of Expanding the board of directors can greatly enhance administrative and oversight effectiveness. The board of directors, which serves as the principal governing entity responsible for making decisions on behalf of the corporation, must operate with efficiency. Pathirawasan (2013) asserts that individuals in managerial roles have significant accountability for a company's financial prosperity. Managers have the responsibility of formulating strategies and making various organisational decisions that affect the entire firm. In addition, they have the responsibility of overseeing the company's assets, leverage, and capital in order to guarantee its profitability. Cadbury (1992) asserts that the membership of the board of directors plays a crucial role in corporate governance by facilitating the attainment of the organization's goals. According to the authors' 2003 study, a larger board size has the potential to better investigate organisational functions and offer improved administration and supervision of the company. The larger board size is more likely to be utilised due to the added capabilities and experience it offers. Expanding the board's dimensions could enhance the organization's ability to effectively oversee and control operations. When it comes to obtaining financial resources, larger boards have a significant advantage over smaller boards. In contrast, Berger et al. (1997) found a negative correlation between the size of the board and leverage. Bopkin, Arko, and Arbour (2009) conducted a study on Ghanaian businesses and found a significant and favourable correlation between the board of directors' size and the company's capital structure. In their study, Yermach and Ofek (1997) discovered a negative correlation between the number of directors in a business and its debt levels. This phenomenon can be attributed to a correlation between larger boards of directors and heightened expectations for management to reduce debt, thereby mitigating the risk borne by investors.Furthermore, the CEO fulfils the role of the chairman of the board of directors. There is a strong likelihood that the same person will be allocated both roles, which will have a negative impact on the overall structure and the profitability of the organisation. By dividing the responsibility for choice control and decision management, the frequency of disagreements among various agencies can be minimised. Fama and Jensen contend in their 1983 article that the positions of CEO and Chairman should be distinct. Conversely, the CEO is accountable for supervising the company's daily activities, while the chairman holds ultimate decision-making power. However, dualism has the capacity to enhance both physical prowess and overall cognitive perception. Boyd (1995) argues that the inherent dualism inside an organisation grants the Chief Executive Officer (C.E.O.) increased power, authority, and control. The study of CEO duality is informed by several views. Based on the findings of Pfeffer and Salanick (1978), directors who possess exceptional evaluative skills are more adept at addressing the business's lack of action and slow progress, and are also more successful in executing strategic decisions. Brickley et al. (1997) found no definitive correlation between dualism and capital structures. This is because dualism and separation encompass both positive and bad aspects. This is due to the fact that dualism confers benefits and generates profits for specific factions, while proving ineffective for others. This elucidates the reason behind this

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phenomenon.The board will consist of a combination of independent directors, board-appointed directors, executive directors, and non-executive directors. Independent directors, also referred to as external directors, have the responsibility of supervising the behaviour of the executive director and ensuring that they do not infringe upon the rights of shareholders. Weisbach (1988) posits that the presence of both independent and outside directors within an organisation enhances communication and collaboration among its members. The examination of executive-level administration. Conversely, the body of literature offers a diverse array of perspectives on the topic. Based on evidence collected by several scholars, there exists an inverse correlation between leverage and board composition. Managers in corporations with robust corporate governance mechanisms tend to choose for scenarios that involve lower degrees of power. Explicitly speaking, in the presence of sufficient and efficient supervision, the interests of shareholders remain intact, and management is more inclined to minimise risk-taking. Kyereboah, Coleman, and Biekpe (2006) found a positive correlation between a company's debt ratio and the proportion of directors on its board.Managers are motivated to make decisions that optimise shareholder profit by utilising remuneration, which plays a crucial part in this process. A conflict of interest arises when the objectives of shareholders and management diverge. Compensation is provided as a means to mitigate agency conflicts and incentivize management to prioritise the interests of shareholders. In order to ensure that managers possess the requisite ability to optimise shareholder wealth, their remuneration should be suitably incentivizing. Abdullah (2006) discovered that there is a detrimental correlation between the earnings of directors and the return on assets (ROA) of Malaysian firms. In their study, Wen et al. (2002) discovered a non-significant and inverse correlation between an organization's capital structure and the remuneration of its directors. In their study, Mian et al. (1996) identified a noteworthy correlation between the capital structure of the company and the compensation received by directors, suggesting a positive association between the two factors. Wen and colleagues (2002) found a negative correlation between capital structure and director salary during their analysis. Furthermore, this research used supplementary control criteria such as profitability, which was assessed through the measurement of return on assets (ROA), asset tangibility, and other similar attributes. Typically, a rise in profitability results in a reduction in the debt ratio. Typically, more profitable organisations have the ability to distribute their resources to a greater range of productive activities, which facilitates their ability to generate revenue.

Methodology

The objective of this study is to examine the influence of corporate governance on capital structure and determine the existence of a correlation between the two. The objective of this study is to examine the corporate governance factors that impact the financial structure of companies listed on the KSE over the period from 2009 to 2011. The sample consists of thirty non-financial firms. A substantial proportion of it relies on secondary data, particularly yearly reports acquired from the businesses encompassed in the sample collection. A comprehensive literature

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ISSN:2958-5074 pISSN:2958-5066
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review is now underway to provide the foundation for this investigation, encompassing sources from both local and foreign populations. This study utilises both quantitative and qualitative approaches, together with gathered data, to conduct its analysis. The discussion of the ideas, rules, and legislation of corporate governance is presented in a qualitative manner; nevertheless, indicators of capital structure are supplied in a quantitative manner. The sample size is reduced to sixty by applying a lag function to the original ninety observations collected from thirty unique businesses over a span of three years. This study encompasses a total of eight distinct aspects. Various independent variables are taken into account during the inquiry. The determinants encompass factors such as the dimensions of the board, its makeup, the ownership structure, the remuneration of directors, and the existence of a dual CEO. The debt ratio is a dependent variable that is determined by other parameters and is utilised to compute the capital structure. Control factors considered in this study are the profitability of the firm and the tangibility of the assets.

Results and Discussion

The conclusion of this study was derived by examining data from thirty distinct publicly traded firms. The data was derived from the annual reports of each of these companies. The variables utilised in this work underwent descriptive statistics, regression modelling, t statistics, covariance and correlation analysis, and other statistical methodologies. The article below presents the final result derived from a comprehensive investigation of the elements. From the presented data, it can be inferred that there is a notable negative correlation between the debt ratio and the number of board members. Given the provided evidence, it is justifiable to infer that the coefficient of board composition exerts a substantial influence on the company's capital structure. In contrast, a negative indication suggests that the involvement of more external directors in the business is leading to a reduction in debt levels. In his 1996 study, Yermack discovered a substantial negative correlation between the size of a company's board of directors and its value. The evidence substantiates this argument. To achieve effective monitoring, it is necessary to establish a comprehensive corporate governance framework and ensure the involvement of a substantial number of independent directors. Non-executive directors safeguard shareholders' interests by creating a system of supervision and responsibility for executive directors. Managers employ conservative leverage to minimise the probability of unfavourable financial results for shareholders. Weisbach (1988) states that the presence of a significant number of non-executive and external directors results in rigorous oversight of the top manager. This is due to the fact that the directors hold a non-executive position. Existing literature confirms that there is an inverse relationship between the debt ratio and the composition of the board of directors. Zingales' (1995) findings indicate that enterprises with restricted or absent shareholder rights have a higher propensity to amass debt compared to those without such rights. In a study conducted by Wen (2002), it was found that there is a notable negative correlation between the debt ratio and the composition of the board of directors. Based on the evidence, it is logical to infer that managers who have a well-functioning and productive corporate governance

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system will opt for a reduced amount of debt. Anderson et al. (2004) discovered a negative correlation between the debt ratio and the membership of the board of directors. The relationship between the dimensions of the board of directors and the company's debt ratio is both positive and statistically significant. According to the facts presented in this source, it is evident that companies with larger boards face more challenges in securing external funding. Organisations that have a larger number of directors on their board of directors are more likely to secure funding as a result of their enhanced reputation. In addition, financial institutions and other organisations perceive that providing loans to companies with extensive boards of directors is a more reliable and safe approach. This is attributed to the perception that these companies possess a higher level of credibility. Firms with higher board sizes have enhanced prospects for raising funds through external finance channels. Moreover, this observation aligns with previous research findings that have been published. Jensen (1986) found a positive correlation between the size of a company's board of directors and its level of debt. Wen (2002) establishes a correlation between the board of directors' size and the company's leverage level. This is because companies with larger boards of directors are more inclined to take on higher levels of debt in order to enhance their future worth. Moreover, Sheikh (2012) and Abor (2007) demonstrated a significant association between leverage and board dimensions. There is a robust and statistically significant negative correlation between the debt ratio and the appointment of a dual CEO. The findings suggest that when the CEO simultaneously holds the position of chairman of the board, they are inclined to choose for a moderate level of debt in order to mitigate and minimise the extra risks associated with excessive debt. Fosberg's (2004) study reveals that these companies accumulate substantial debt while simultaneously upholding distinctive leadership positions at both the operational and board levels. In their investigation, Berger and colleagues (1997) identified a correlation between the two variables. Businesses that fail to undertake thorough audits of their CEOs experience reduced levels of debt accumulation, as stated by their report. In their investigation, Coleman and Biekpe (2006) identified a noteworthy and negative correlation between the debt ratio and the existence of a dual chief executive officer. According to his statement, the agency incurs higher expenses when an individual simultaneously holds the positions of chairman of the board and chief executive officer. Consequently, this deters external lenders from offering financial support to such companies. Sheikh (2012) found that the CEO's engagement in multiple employments is associated with a negative correlation with the debt ratio. Moreover, there is a slight negative correlation between the debt ratio and director remuneration. In their scientific investigation, Wen et al. (2002) found a negative correlation between director compensation and debt ratio. The identification of a negative correlation between the two variables indicates that an elevated director remuneration is linked to a reduction in debt. By implementing this methodology, internal conflicts within the organisation are reduced and the level of involvement from management is enhanced. Consequently, augmenting managers' remuneration will incentivize them to adopt a more cautious strategy towards debt management, thereby diminishing the likelihood of financial losses for board members. Furthermore, Abdullah (2006) found that there

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is an inverse relationship between director remuneration and debt ratio. Sheikh (2012) discovered a negative correlation between the debt ratio and the remuneration given to directors. The regression analysis reveals a statistically significant inverse correlation between the level of ownership concentration and the debt ratio. Owners of blocks exert considerable influence on management decisions. Moreover, they enforce management to execute their duties in a manner that is advantageous to the organisation. Our findings strongly contradict past research, as the majority of studies have consistently found a positive correlation between ownership structure and debt ratio. Mehran supervised the research conducted by Sheikh (2012) and Wen et al. (2002) in 1992 and 1992, respectively. These studies discovered a strong and statistically significant correlation between ownership concentration and debt ratio. The findings of Berger et al. (1997) corroborate this conclusion. Demsetz and Villalonga (2001) discovered that there was a weak and inverse relationship between the two variables. When ownership is distributed, a significant number of owners may accumulate extra debt as each member of the ownership group possesses a limited number of shares in the company. This is due to the fact that each owner possesses a limited quantity of shares. High ownership concentration often leads to risk aversion among people who possess a significant amount of a company's shares, hence reducing the company's capacity to utilise leverage. A situation that is managed. A substantial statistical correlation was observed between profitability and debt ratios, suggesting a negative correlation between the two variables. By adding this information, the reduction in debt ratio will be directly proportionate to the magnitude of the profit. This result aligns with previous discoveries. The study conducted by Kester and Kolb (1991) exemplifies this phenomenon, since they found a robust and inverse correlation between the debt ratio and itself. Moreover, researchers such as Booth et al. (2001), Fraser et al. (2006), Raajan and Zingals (1995), and Bevan and Danbolt (2004) found a significant negative correlation between the two factors. Organisations that are more profitable tend to have lower amounts of debt, unlike organisations that have lower levels of profitability. According to the principle of ascending order, wealthier companies have more options when it comes to choosing asset allocation and investment strategy. This phenomenon can be attributed to their enhanced capacity to utilise retained earnings as leverage. The organization's dependence on debt will diminish as its profitability increases. Moreover, there is a direct correlation between the debt ratio and the existence of tangible assets; nevertheless, this relationship does not meet the statistical significance requirement. There is a direct correlation between the quantity of fixed assets owned by a company and its inclination to pursue loan financing. As the availability of immovable assets increases, the value of the collateral also increases, which instills greater confidence in loan holders regarding the commercial lending industry. The results align with other research conducted by Booth et al. (2001), Raajan and Zingals (1995), Sheikh (2012), and Wang (2012), all of whom observed a direct correlation between profitability and debt ratio.

Conclusion

Journal of Business and Management Research
ISSN:2958-5074 pISSN:2958-5066
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An empirical investigation was carried out from 2009 to 2011 to ascertain the influence of corporate governance on the capital structure of thirty non-financial companies that are publicly traded in Pakistan. Our research findings indicate that the implementation and maintenance of robust governance systems can enhance a company's total value. The study's findings indicate that corporate governance significantly influences an organization's capital structure. Moreover, corporate governance characteristics are significant in explaining the financial resource allocation choices of Pakistani firms. The main objective of this research is to investigate the impact of different corporate governance factors on the composition of a company's capital structure. The debt ratio enables us to analyse the company's capital structure. The results suggest that there is a negative correlation between the debt ratio, which measures the firm's capital structure, and other characteristics of the company, such as the makeup of the board, the presence of a dual CEO, the concentration of ownership, and profitability. According to the gathered evidence, this seems to be the situation. The statistical significance of this link is evident. A substantial and positive link has been found between the size of the board of directors and the debt ratio. Conversely, there is a direct correlation between director remuneration and the debt ratio; however, this association does not meet the threshold for statistical significance. Moreover, there exists a direct correlation between the debt ratio and asset tangibility, albeit it is not particularly significant. The inverse correlation between board composition and capital structure suggests that boards with a significant number of non-executive directors are more inclined to reduce debt exposure due to increased scrutiny and supervision. The observed inverse correlation between CEO duality and capital structure indicates that companies where the CEO also holds the position of chairman of the board of directors are more inclined to refrain from taking on further debt. Based on the evident correlation between the size of a company's board of directors and its borrowing capacity, it may be inferred that organisations with larger boards have the potential to accumulate greater amounts of debt. A larger quantity of tangible assets provides concrete proof to the funding source that a higher level of fixed assets already exists. These enduring assets might serve as security to facilitate the establishment of trust. Large corporations have a more advantageous position to secure funding from external sources due to their larger access to resources. Regarding corporate governance, there exists a robust correlation between capital structure and these two factors. Modifications to the policies governing a company's capital structure possess the capacity to substantially enhance and augment the company's total value. The examination currently ongoing in Pakistan places significant attention on the matter of corporate governance. Several factors contribute to the success and growth of a corporation, such as a robust monitoring system, established protocols, legal compliance, and appropriate infrastructure. In the framework of Pakistan's corporate structure, the notion of efficient corporate governance in Pakistani companies is a relatively new advancement. The Pakistan Institute of Corporate Governance and the State Enterprises Commission of Pakistan (SECP) are now making significant contributions towards enhancing Pakistan's corporate governance systems. These contributions are currently being made.

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ISSN:2958-5074 pISSN:2958-5066
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